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REGIONAL COOPERATION

Summary of the Economic Survey of Europe in 1992-1993

Note by the Secretary-General

The Secretary-General has the honour to transmit to the Economic and Social Council, annexed to the present note, chapter 1 of the Economic Survey of Europe in 1992-1993, prepared by the Economic Commission for Europe.

* E/1993/100.

Annex

OVERVIEW AND POLICY ISSUES

(i) Introduction

For the economies of Europe and North America 1992 was another disappointing year. The recovery of the United States economy from recession was very slow and, until late in the year, was also very hesitant. By the turn of the year, however, the United States recovery was beginning to appear stronger and more settled, thus providing one of the few positive developments in the ECE region. In western Europe hopes of stronger output growth proved unfounded: the last issue of this *Survey*, which was more pessimistic than most other forecasts at the time, thought there might be a slight improvement from average growth of 1 per cent in 1991 to about 1.5 per cent. In the event, annual growth was unchanged and there was a sharp weakening of economic activity in the second half of the year.

In eastern Europe,[1] 1992 was another year of falling activity, the fourth in succession, the cumulative drop in output being just over 30 per cent. Nevertheless, there were signs that the downturn was beginning to bottom out and in a few countries there were signs of a recovery during the year. In Poland there was actually a small increase in GDP for 1992 as a whole. However, in Russia, the other CIS states and the Baltic States, the slump in output deepened through 1992. The differences among the transition economies have widened a lot: in some, substantial progress has been made in setting up the institutions of a democratic society and a market economy, and there are also hopes of an improvement in economic activity; in others, institution-building is still at a relatively early stage and subject to considerable strains from political fragility and, in some cases, from civil war and armed conflict. For many people in the eastern countries the dominant issue is not so much the "transition process" as immediate survival.

Personal insecurity, albeit at a different level, has increased sharply for many people in the western economies. At the end of 1992, 30 million people were unemployed in western Europe and North America, an increase of more than one third in two and a half years. In December, the unemployment rate averaged just under 10 per cent in western Europe compared with 8.9 per cent a year earlier. In many countries the proportion of people unemployed for over a year has risen sharply, to a third or more of total unemployment in several cases. One of the most disturbing features of the current situation is the exceptionally high rates of youth unemployment. In Spain a third of young people of working age (under 25) are without a job and the proportion is close to 30 per cent in a number of other countries including France and Italy. The enormous economic waste and the potential for serious social problems implied by such figures is obvious. Not surprisingly unemployment began to move to the top of the economic policy agenda in 1992.

In eastern Europe unemployment is more difficult to measure than in the west, but the data available point to a rapid increase in 1992. At the end of the year some 6.5 million people were registered as unemployed, with rates ranging from 5 per cent in Czechoslovakia to 14 per cent in Poland and even more in the Federal Republic of Yugoslavia (Serbia and Montenegro). Figures for unemployment in the former Soviet Union are very unreliable and the registered figure of some 1 million is probably too low. In all the transition economies unemployment is expected to start rising rapidly as privatization gets under way and bankruptcy laws are brought into effect. Concern at the social implications of this development explains the anxiety to get social safety nets into position and the increasing willingness of western countries to support their construction with technical and financial assistance.

In other parts of the European region the "new order" has brought insecurity on a completely different scale. In the violent conflicts which have followed the break-up of the Soviet Union and Yugoslavia more than 200,000 people have been killed (of which some

1 *Eastern Europe*, as employed in the text and tables of this publication, refers to the formerly centrally planned economies of Albania, Bulgaria, Czechoslovakia, Hungary, Poland and Romania, and the successor states of the Socialist Federal Republic of Yugoslavia. Czechoslovakia, which separated into the Czech and Slovak Republics at the beginning of 1993, is dealt with as a policy-making entity for 1992, but data for the two new states are shown separately where available. Among the newly-independent republics of the former *Soviet Union*, a distinction is made between the *Baltic states* (Estonia, Latvia and Lithuania) and the majority of the remaining republics which cooperate in the institutions of the Commonwealth of Independent States – the *CIS* countries.

85 per cent in Yugoslavia) and around 3 million have been displaced.[2]

The revolutions of 1989 in eastern Europe were accompanied by euphoric proclamations of a "new world order". That phrase now appears less frequently in the lexicon of international statesmen. Indeed, a west European foreign minister has recently dismissed the phrase as "Utopian folly" because it "promised more than we shall ever be able to perform". The best that can be expected is "action to avert the continuing slide into disorder".[3] A fairly large share of that disorder – actual and potential – now lies within the borders of the former communist régimes of eastern Europe and the former Soviet Union. These remarks may appear somewhat bleak but they also indicate the beginning of a more realistic appraisal of the scale of the problems in the transition economies and of what is needed to overcome them. At the end of 1989 there were excessively optimistic expectations about how long it would take and how much it would cost to create new market economies in the east. At the same time there was a certain disengagement of the western countries from the problems of the east. The threat of nuclear war was over and the problems of transition could hopefully be left to the international financial institutions and, relatively quickly, to private capital both domestic and foreign. That sanguine view is now being sharply revised, especially in the light of developments in Russia over the past year. There now seems to be a realization that the revolutions of 1989 posed a much greater challenge to the economic and foreign policies of the western countries than was previously supposed, and that is reflected in the greater urgency with which action to assist Russia is now being discussed.

(ii) The western economies

The economic situation in the western countries is now very weak and the forecasts for growth in 1993 have been lowered since last autumn. For western Europe and North America combined, the annual growth rate of real GDP now appears likely to be somewhat less than 2 per cent in 1993. This outcome is slightly better than in 1992, but there is an increasing divergence between western Europe and North America.

In the United States the recovery now appears to be firmly established, even if the remarkable strengthening of activity in the second half of 1992 partly reflected special factors. Real GDP is expected to rise by some 3 per cent in 1993 (annual change).

The outlook for western Europe is instead rather sombre. Against a background of turbulent foreign exchange markets and with the German economy moving into recession, prospects for 1993 have deteriorated sharply and consumer and business confidence are now at very low levels. After growth of only 1 per cent in 1992, stagnation in west European GDP in 1993 now seems increasingly likely.

With low or zero rates of output growth there will be a further rise in the number of persons unemployed. In western Europe employment is therefore likely to continue to fall and the unemployment rate to move significantly above 10 per cent. In the United States the labour market is expected to improve in 1993, but employment growth is likely to be relatively modest.

Among the four major economies in western Europe, real GDP is likely to fall in Germany, France and Italy in 1993. Only in the United Kingdom is GDP expected to grow, albeit by a small amount, as it emerges from its longest recession in the post-war period.

Among the smaller countries the outlook is for a pervasive slow-down in economic growth, with a number of countries close to stagnation or even an absolute fall in total output. The prospects of most of these smaller economies are closely tied to the outlook for Germany.

High interest rates, resulting from the tightening of monetary policy in Germany, and the commitment to fixed exchange rates are major factors behind the economic downturn in western Europe. The strains of this combination on other countries increased throughout 1992 to the point where the United Kingdom and Italy decided to leave the ERM, and several other countries devalued within the system or severed unilateral exchange rate links to the ECU.

German monetary policy has been progressively eased since 15 September 1992 against a background of tensions within the ERM, but the cuts have been relatively small so that on average real interest rates are still high.

Hopes of significantly larger and more rapid cuts in German interest rates have been pinned on a successful conclusion of the so-called Solidarity Pact. The Pact, in principle, is designed to allow for the continuation of very high support payments to the east German economy. This requires the full integration of the east German *Länder* into the established revenue-sharing system between the federal government and the west German *Länder* as from 1995. At the same time the Pact is also an integral part of a broader package of measures designed to raise revenues and curb expenditures and so pave the way to a medium-term reduction in the public sector deficit.

It is also an essential part of the strategy to convince the trade unions that the severe deterioration in the east German labour market calls for wage restraint and that the insistence on a very rapid closure of the wage gap conflicts sharply not only with the objective of preserving jobs but also with the need for more stringent budgetary policies.

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2 Based on figures in the *New York Times*, 7 February 1993 and the weekly press release of displaced refugees in former Yugoslavia, issued by UNHCR Geneva.

3 Speech on "The New Disorder" by Mr. Douglas Hurd, delivered at the Royal Institute for International Affairs, Chatham House, London, 27 January 1993.

However, the agreement reached in March 1993 has actually clouded the prospects for a significant reduction in the deficit. The main emphasis is on raising tax revenues *inter alia* by re-introducing the surcharge on income and corporate taxes as from 1995, while there will be only limited cuts in expenditure. The immediate impact is to increase the public sector borrowing requirement in 1993 and possibly beyond. Also, the trade unions have not yet changed their position on the question of the catch-up in eastern wages.

Thus, the Pact, as agreed, does not appear to pave the way to a substantial change in the policy mix in Germany. Given the uncertainty surrounding future budget deficits and the continuing high rate of inflation, it therefore seems likely that for the first half of 1993, at least, the Bundesbank will continue to lower official interest rates only slowly and cautiously, largely in response to the weakening of economic activity and changes in the inflation rate.

The easing of German monetary policy since September 1992 has been only hesitantly followed in other countries because of continuing speculative pressures on their exchange rates. In France there is now a sizeable margin over German short-term rates which translates into an even bigger gap in real terms, given that the inflation rate is lower in France.

In those west European countries which abandoned fixed exchange rate targets against the deutsche mark or left the ERM, monetary policy has been substantially eased since the final quarter of 1992, but the scope for further easing is now constrained because of the inflationary implications of further currency depreciation.

Although there has been some scope for monetary easing, governments in most of western Europe see hardly any room for a discretionary relaxation of fiscal policy to counter the forces of recession. Governments' financial positions generally deteriorated in 1992, mainly because of the impact of lower than expected economic growth on revenues and expenditures. Most governments will continue to allow the automatic stabilizers to work in 1993 but at the same time are pursuing efforts to stabilize discretionary spending and reduce their borrowing relative to GDP. The pressure for fiscal restraint has been increased considerably by attempts to meet the Maastricht convergence criteria prior to European Monetary Union. None of the west European countries will be able to meet these criteria in 1993.

In the United States monetary policy was considerably eased in 1991 and 1992 and the need for further relaxation appears now to be much reduced given the strengthening of the economy in the second half of 1992.

The new administration has announced a package of measures designed to curb significantly the budget deficit in the medium term. At the same time it is also intending to provide a short-term fiscal stimulus (equivalent to about 0.5 per cent of GDP) because of concerns about low employment growth. The announced stimulus does not appear to have undermined credibility in the medium-term plan to curb the deficit; long-term interest rates have eased.

The outlook is for steady growth in the United States in 1993. Although lower interest rates have eased debt service burdens, private sector demand will continue to be restrained by balance sheet problems and by the glut in commercial real estate. The need to consolidate budget deficits will check growth in government expenditures. Given the relative strength in domestic and foreign demand, changes in the real foreign balance will act as a drag on economic activity levels.

Any forecast of central tendencies is, of course, surrounded by a margin of error. The general feature of short-term forecasts prepared for the western economies over the past two years or so has been the presence of rather large downside risks, largely reflecting the difficulties of predicting consumer spending against a background of very high debt-income ratios and falling asset prices. Although balance sheet problems have been easing recently, they are still very important and more negative "surprises" cannot be excluded, especially in western Europe, where the deterioration in the labour market is lowering the prospects for income growth and increasing uncertainty for individuals. Another important uncertainty is how the large changes in real effective exchange rates will affect net exports and domestic activity levels in the various countries and the scope for further monetary easing in Germany in 1993.

With prospects of only low output growth and a further worrisome rise in unemployment, there would appear to be a need for closer macroeconomic policy coordination among the major industrialized economies, the general objective being to enhance the scope for output and employment growth. A step in this direction was taken by the European Community which, at the December 1992 Edinburgh summit, adopted a package of measures (the so-called "growth package") designed to stimulate investment demand. But implementation appears to be slow and the overall impact is expected to be rather modest. Moreover, closer coordination of economic policies does not currently appear to be high on the agenda of the G7.

The medium-term outlook for western Europe is also more uncertain than it appeared in 1990. One important uncertainty concerns the prospects for future monetary union. The European Council Agreement at Maastricht in December 1991 was seen as pushing for the culminating stage of a "Europe without borders". However, the conditions laid down for economic convergence, to be met by 1997, are relatively severe and the process of meeting them is likely to lead to fairly restrictive monetary and fiscal policies. To meet the inflation requirement most countries will try to avoid further currency re-alignments but this may prove difficult if persistently large government budget deficits in Germany force the Bundesbank to keep interest rates relatively high. Also, the absence of labour market indicators among the convergence criteria will not encourage initiatives by individual countries to stimulate growth. Economic growth in western Europe is therefore likely to be rather subdued for the rest of

the 1990s. This is in sharp contrast with the optimism prevailing at the end of the 1980s in anticipation of the single European market which entered into force at the beginning of 1993. This optimism for the "decade of Europe" appears to have been dampened since the Maastricht treaty was signed.

(iii) The transition economies

Output continued to fall quite substantially in most of the transition economies of eastern Europe and the former Soviet Union in 1992. In eastern Europe GDP/NMP fell on average by about 10 per cent, bringing the aggregate decline since 1989 to more than 30 per cent. However, the economies of eastern Europe are becoming increasingly heterogeneous, partly reflecting the different pace and degree of success with which reforms have been introduced, and it is therefore difficult to generalize about short-run economic changes. The estimated falls in GDP last year ranged from some 27 per cent in the Federal Republic of Yugoslavia to some 4-6 per cent in Hungary, while in Poland there was actually a small increase. Data for industrial production show that a recovery began to get under way in Poland in the second quarter of 1992, while in Hungary and Czechoslovakia the decline appeared to have come to an end. However, in January 1993 industrial output began to fall again in Hungary. Nevertheless, for virtually all the east European countries, except Romania, the falls in output last year were smaller than in 1991 (although the improvement in Bulgaria was small).

However, in Russia, the other CIS countries and in the Baltic states the slump in production deepened considerably in 1992. In Russia NMP fell by 19 per cent, and from 11 per cent in Belarus, where reforms have been introduced in a limited and slow way, to more than 40 per cent in Armenia, which is at war with and subject to an economic blockade by Azerbaijan.

In the Baltic states the falls in output were even larger than in the CIS countries: 28 per cent in Estonia, 44 per cent in Latvia and 35 per cent in Lithuania. These massive cuts in production in a single year appear to be largely due to a large terms-of-trade loss, a result of having to pay much higher prices for Russian oil from the beginning of 1992, and some disruption in supplies.

In general, industry has tended to bear the brunt of the fall in output in the transition economies, although there has now been some recovery in Poland. *Agricultural output* added to the decline in 1992, falling by 9-13 per cent in most of eastern Europe and by 10 per cent or so in the CIS. The *construction* sector has continued to decline, although the first signs of recovery have appeared in Czechoslovakia. *Housing* construction appears to have declined again in most countries. Data on *services* are still limited, especially for the CIS, but their share in total output appears to be rising in eastern Europe in some cases (Hungary, for example) quite sharply. Indeed, in eastern Europe the only sectors to show any growth at all in employment were banking, finance and business services.

Statistics on the scale of activity in the *private sector* are still very limited, but those that are available indicate a rapid growth, especially in eastern Europe and particularly in agriculture, construction, trade and other services. Their share in domestic output appears to have increased substantially in 1992, from 9 per cent in 1991 to 20 per cent in Czechoslovakia, and from 5 to 10 per cent in Bulgaria. In Hungary the share of the private sector was around 25-35 per cent of GDP last year, with 45-50 per cent in Poland, and perhaps 26 per cent in Romania. The importance of private producers has also risen in the CIS countries. The numbers, although not always comprehensive or very reliable, suggest that despite all the disruption and uncertainty in the transition economies, significant progress is being achieved in one of the key areas of the transition process.[4]

National accounts statistics showing the components of demand are still fairly limited, but there appears to have been a slight recovery or stabilization of domestic demand in Czechoslovakia and Poland, and a further slight fall in Hungary. Elsewhere the declines were much larger.

The signs of recovery in Poland and perhaps Czechoslovakia are strengthened by the decline in *fixed investment* coming to an end. Zero growth in 1992 compares with falls of 4 and 27 per cent respectively in 1991. Investment is still falling in the rest of eastern Europe although less rapidly than in 1991. In Russia and the other CIS countries the slump in fixed investment deepened last year (down by 45 per cent in Russia), which is not surprising given the economic turmoil and uncertainty arising from hyperinflation.

Data on *private consumption* are also scarce but proxy variables such as retail sales and real income per head suggest that the squeeze on consumption and material living standards has continued. However, in Czechoslovakia private consumption rose (by about 5 per cent) and also in Poland. The falls in real consumption have been particularly severe in Russia and the other CIS countries, mainly because of the squeeze in real incomes as inflation outpaced the increase in money incomes by a considerable margin. In Russia the number of people officially classified as living in poverty (i.e., below the minimum subsistence income) more than doubled in the twelve months to the end of 1992, from 12 per cent to 29 per cent of the population. A similar development appears to have occurred in most of the other CIS countries. In considering the impact of the transition period on living standards and people's sense of personal security, it should also be remembered that public services – health, culture, education – have also been hard hit by tight fiscal policies, that social safety nets for the unemployed are still rudimentary in many countries, and that increasing income inequalities are increasing social tensions as larger

[4] For a detailed discussion of privatization developments, see section 3.6. On progress in other aspects of market reform, see section 3.5.

numbers of people fall below the official poverty lines. However, it must be remembered that the statistical dimensions of these social consequences of the adjustment process are still very imprecise.

Unemployment began to rise sharply in eastern Europe in 1991 as industrial restructuring got under way, as bankruptcy laws were put into place, as privatization began to spread into traditional sectors of the economy, and as market forces began to influence the behaviour of the "new" entrepreneurs.

Registered unemployment continued to rise steadily in all countries of the region in 1992, with the notable exception of Czechoslovakia. In most of the east European countries rates of unemployment continued to rise sharply over the year, although more slowly than in 1991. Nearly 6.5 million people were registered as unemployed in December 1992 (compared with 5 million in December 1991), with the unemployment rate ranging between 5 per cent in Czechoslovakia and nearly 25 per cent in the Federal Republic of Yugoslavia. The largest increase was in Hungary where the rate of unemployment nearly doubled last year to 12.3 per cent of the labour force in December 1992. Employment in large Hungarian enterprises fell by nearly 40 per cent between 1989 and the autumn of 1992, far too large to be quickly absorbed by the still small, private enterprise sector. In Poland, where both the rate and the level of unemployment doubled during 1991, there was some slow-down in the deterioration of the labour market in 1992, particularly in the second half of the year. Nevertheless, the number of unemployed exceeded 2.5 million and the unemployment rate reached nearly 14 per cent at the end of the year. In striking contrast, there was a fall in the level and the rate of unemployment in Czechoslovakia after the spring: the rate of unemployment fell to 2.6 per cent in the Czech Republic and 10.4 per cent in the Slovak Republic at the end of 1992 (down from 4.1 per cent and 11.8 per cent at the end of 1991 respectively). This substantial improvement occurred while employment in large enterprises continued to fall sharply (by some 14 per cent). Although a tightening of the eligibility rules for unemployment benefit, in January 1992, and the expansion of public employment programmes played a role, much of the fall appears to be genuine and to reflect the strong performance of the private sector, particularly in the Czech Republic.

Despite the considerable understatement of the level of unemployment in the official statistics of the former Soviet Union, unemployment was also increasing in the successor countries during 1992: in the twelve months to the end of 1992, the number of registered unemployed is estimated to have reached about 1 million. Nevertheless, unemployment was much lower than might be expected given the size of the fall in output: the unemployment rate was less than 1 per cent in December 1992 in all republics except Armenia, Estonia and Latvia, where it ranged between 3.5 and 2 per cent. In the former Soviet Union in particular and to a lesser extent in most of the east European countries, the initial response of unemployment to the decline in output was delayed because of soft budget constraints, slow privatization, and sharply falling real wages, which encouraged the hoarding of labour. This hidden unemployment is clearly reflected by large productivity losses, particularly in the industrial sector. Given the expectation of a further deterioration in output, particularly in the CIS countries, it seems likely that the rise in open unemployment will soon begin to accelerate sharply. In the absence of comprehensive social safety nets that would inevitably increase the dangers of social and political instability.

High rates of *inflation* are still a major problem in all of the transition economies, although its intensity varies considerably among individual countries.[5] Annual (year-on-year) inflation rates fell in a number of east European countries in 1992, and strikingly so in Czechoslovakia (from over 50 per cent in 1991 to 11-10 per cent) and Bulgaria (from 340 to 80 per cent). The rate also fell in Hungary and Poland, to 23 and 43 per cent respectively. Elsewhere inflation accelerated and was over 200 per cent in Albania, Romania and Slovenia. In the Federal Republic of Yugoslavia hyperinflation has been unconstrained since April 1992: for the year as a whole prices rose by more than 9,000 per cent and were accelerating sharply in the early months of 1993.

In Russia and the other members of the CIS both the initial impact of the January 1992 price reform and the "after shocks" were much greater than expected and proved difficult to control. There was some deceleration to mid-summer but the rate of increase then picked up again after the central bank abandoned any serious attempt to restrict the expansion of credit. In Russia and most of the CIS states prices were rising at about 25 per cent a month in the final months of 1992. In contrast to the CIS countries, the Baltic states have rapidly reduced their monthly inflation from double-digit rates at the beginning of 1992 to some 3 to 5 per cent by the end of the year, a result of effective monetary reforms and restrictive monetary policies.

The *foreign trade*[6] of the transition countries in 1992 continued on the lines of the previous two years, namely, a continuing and probably accelerating collapse in intra-eastern trade, falling trade with the western market economies in the case of the former states of the Soviet Union, and continued significant growth in the trade of eastern Europe with the west.

In the former Soviet Republics, the disruption of inter-republican trade links, rapid inflation, and a monetary and payments crisis have all contributed to a large fall in trade, not only with former CMEA partners but also with the western market economies.

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5 For a detailed discussion of inflation see section 3.2(ii).

6 See section 3.3 for a detailed discussion of trade and payments. It must be emphasized that the data used for analyzing trade developments is even more fragile than in the past.

One of the most significant developments in trade has been the sustained growth of exports from eastern Europe to *western* markets over the last four to five years. Bulgaria, Czechoslovakia, Hungary and Poland all maintained high rates of volume growth in the first three quarters of 1992, although there was some deceleration from 1991 in Hungary and Poland. Exports of manufactures have risen faster than the growth in the total volume of total exports with consumer goods and engineering leading the way. This performance indicates that a wide range of east European goods can meet the quality requirements of western markets despite opinions to the contrary a few years ago. The attempt to offset part of the destruction of trade with other eastern countries with exports to the west also shows increasing adaptability on the part of eastern exporters and their success has provided the only source of demand growth for most of them.

Assessing the *short-run prospects* for the transition countries is extremely difficult because the problems they are grappling with are essentially structural, not cyclical. The purpose of the reforms is to transform the very institutional structures and patterns of behaviour in which stability is necessary for building short-term forecasting models. It is therefore misleading to employ the same business-cycle vocabulary which is appropriate for the west to the situation in the transition economies.[7] As noted above, there has been an upturn of industrial production in Poland and preliminary estimates suggest a rise in GDP in 1992. Hesitant signs of an upturn in industrial output also appeared in the last quarter of 1992 in Hungary and Czechoslovakia. However, recovery in a transition economy must mean much more than an end to the slump in output, highly welcome though that may be. When the basic infrastructural reforms are in place a strong and sustained rate of growth, perhaps in the neighbourhood of the 7 per cent or so annual rate achieved by western Germany in the 1950s, will be required. For that demand will need to expand and there must be enough capacity to meet it without creating inflationary pressures; and that, in turn, will require a rapid growth of fixed investment both in the private and public sectors. For most of the transition economies these conditions are still far from being met: inflation rates are still being curbed, government expenditures are being curbed and the stance of macroeconomic policy in general is not yet conducive to the expansion of fixed investment and the correction of inappropriate industrial structures (see below). From this perspective, one of the most encouraging developments in Poland last year was a small rise in fixed investment in equipment which is expected to accelerate in 1993 and 1994.

However, on the basis of government forecasts, which have been repeatedly over-optimistic in the last three years, the outlook for the leading reform countries is for some recovery in 1993, albeit slow and hesitant. In Poland GDP growth of 3 per cent is currently forecast, while in Hungary the uncertainties are reflected in a range of zero to 3 per cent.

The Czech government was forecasting growth in 1993 at 1-3 per cent at the start of the year, but this is now surrounded by growing uncertainty about the size of the effects on trade between the Czech and Slovak Republics following the break-up of the Czechoslovak Federation. At first it was estimated that there might be a drop in mutual trade of some 10 per cent from last year's monthly average; this was later increased to 30 per cent. However, preliminary data for the first month in 1993 under the new régime suggest a fall of 60 per cent.[8] If this collapse in mutual trade is not contained, the Czech government's hopes of 1-3 per cent GDP growth in 1993 are likely to be disappointed while Slovak GDP, which is relatively more dependent on mutual trade than the Czech Republic, will decline much more than is currently expected.

In all the other east European economies, total output is expected to continue to fall in 1993, although, it is hoped, at a somewhat lower rate than last year.

Forecasts for the CIS countries other than Russia are not generally available, and even those for the latter may be little more than subjective opinions or hopes on the part of beleaguered officials. The stabilization of the Russian economy is still the crucial and urgent issue, and that in turn must require solutions to the institutional problems of establishing monetary control, the clarification of monetary and currency relations among the CIS members, and arrangements for creating effective payments arrangements among them in order to arrest and reverse the disastrous decline in inter-republican trade. But progress on these matters must wait upon the resolution of even more fundamental issues of constitutional authority and popular legitimacy.

Finally, the short- and long-run outlook for the transition economies can also be significantly influenced by external developments. As already noted, some of the east European economies have benefited from rapid export growth, especially to western Europe. That in turn was facilitated by the strong import boom in Germany in 1990 and 1991, and by a lowering of import barriers in western Europe and elsewhere. Both factors now look to be less favourable in the next year or so. There is little that can be done to quickly reverse the slow-down in west European import demand, but it is possible for western policy makers to resist a reversal of the trade liberalization which has been achieved and to extend it as quickly as possible.

(iv) The siren call of "shock therapy"

A question which continues to figure prominently in the public discussion of the transition process is whether eastern governments should adopt a gradual approach to market reforms or go for them in one "big

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[7] See United Nations Economic Commission for Europe, *Economic Bulletin for Europe*, Vol.43(1991), New York, 1991, pp.5-6.

[8] See section 3.3(v).

bang" or a dose of "shock therapy".[9] It is reckoned by many observers that the policies pursued in Poland, Czechoslovakia and Bulgaria, for example, can be categorized as "shock therapy" while those in Hungary can be described as "gradualist". In Russia the programme introduced by the Gaidar government[10] at the beginning of 1992 is widely regarded as an example of "shock therapy", while the critics in the Congress of People's Deputies are labelled as "gradualists" or "reactionaries" depending on the observer's point of view. The Markovic programme of 1989 in the former Yugoslavia is another example of "shock therapy" and the ex-German Democratic Republic was subjected to the most severe and comprehensive shock of all. If the metaphor of "shock therapy" is taken literally, namely, that it provides quick and lasting relief from a severe disorder, then the record is not a successful one, but, clearly, is too simple an approach which just shows up the limitations of the metaphor.

The important distinction between the various transition economies lie not so much in whether they consciously chose shock therapy or gradualism but in the initial conditions in which they started their reforms and the particular "disorders" which had to be dealt with. By the end of 1989 the Polish economy was characterized by pervasive shortages and the imminent prospect of hyperinflation. The central plank of the government's programme in January 1990 therefore consisted of a fundamental shift in macroeconomic policy to deal with the threat of hyperinflation. To do this swift and decisive action was necessary and both experience in other parts of the world and a large body of economic analysis would support the Polish approach as the correct one. The Balcerowicz Plan also included instant price and trade liberalization which are more controversial (see below), but it was also quite clear that the Deputy Prime Minister was not suggesting a "big bang" approach to privatization and other institutional reforms. Thus Polish "shock therapy" was successful in heading off the disorder of hyperinflation, but in curing the more fundamental, structural disorders of the Soviet-type economy progress has inevitably been more gradual. In Hungary, by contrast, there was no need for macro "shock therapy" insofar as inflation was fairly low, while the relative prominence of problems requiring structural solutions, which had been underway for many years under the previous regime, meant that a more gradualist approach was unavoidable. The Czechoslovak situation was again very different in that the new government inherited an economy with no serious macroeconomic imbalances but, unlike Hungary, had undergone little structural reform in the previous twenty years or so. The government therefore went for rapid price and trade liberalization, backed by tight controls on wage increases, but in most other respects the process of reform has been more gradual and preceded by careful preparation.[11]

The argument between "shock therapists" and "gradualists" is not in fact very helpful because the dichotomy is a false one. The ability of a country to change – and to adjust to change – depends crucially on the nature and strength of its economic, political and legal institutions, on its social cohesiveness and traditions, and on the conditions prevailing at the start of the process of reform. These factors, which obviously vary among countries, will largely determine the speed of the transition to a market economy which will also be greatly influenced by the ability of political leaders not only to establish credibility in their economic programmes but also to create and sustain a popular consensus behind a positive vision of the society at which they are aiming. In seeking popular support it is also important to make an honest attempt at estimating the scale, duration and distribution of the costs of adjustment, and to prepare measures for attenuating their impact on the most vulnerable sections of the population. Since the costs of the transition will appear much more quickly than the benefits, the degree of social support, which in part will depend on the presence of safety-nets, will determine the scale of the shock that can be supported without derailing the entire programme.

These considerations tend to be swept aside by the advocates of shock therapy who just dismiss the case for gradualism. The discussion is also clouded by a failure to specify clearly what policies are included within the domain of the shock treatment: as noted already, there is little disagreement over the need to include urgent measures to deal with the threat of hyperinflation, but the advocates of this approach also include structural measures such as trade liberalization and even privatization. There is also considerable vagueness as to what time period "shock therapy" refers to. The metaphor implies a short, sharp shock with immediate effects, something not too far removed from the text-book, neoclassical abstraction of instantaneous and costless adjustment to a new equilibrium. That should not be taken too literally, but can a three-year transition recession still qualify as shock treatment? The language of shock therapy is fuzzy[12] but it clearly promises a more rapid adjustment than is possible in practice and as a result must bear some responsibility

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9 Perhaps it is a sign of changing expectations that the more exuberant "big bang" has been pushed aside in the last year or so by the more gloomy "shock therapy".

10 For a discussion of the Russian programme see section 3.4 below.

11 The discussion of "shock therapy" is frequently confused by the use of conventional terms in innovative ways. This is particularly the case with "convertibility" the radical adoption of which is usually seen as an important element of a shock programme. Governments frequently imply that their currencies are convertible while retaining an array of controls on access to foreign currency. Thus, for most of 1991, Czech and Slovak enterprises still had to obtain clearance from the National Bank for imports above 6 million koruna. In Romania current account convertibility was introduced in November 1991 but import licensing was not abolished. "Shocks" are not always what they are claimed to be.

12 The lack of a theoretical foundation is evidenced by the frequent resort of "shock therapists" to a bewildering array of metaphors. Some are used to describe their own recommendations – "big bang", "shock therapy", "cold turkey", and "jump start". But most of them are polemical devices to discredit contrary arguments – "you don't pull a tooth slowly" or "amputate a leg bit by bit" and "you can't cross a chasm in two jumps", etc. The comparison of the transition process to an attempt to "turn fish soup into fish" comes from a completely different school and would appear to be a cry of despair against the second law

for the current disappointment and disillusion in many of the transition countries (see below).[13]

"Shock therapists" also tend to overstate the extent to which their recommendations are based on experience and rigorous research. The argument, for example, that trade and price liberalization cannot be introduced gradually is simply not true. In western Europe wartime price and other controls were phased out in line with supply-side improvements[14] so as to avoid setting off an inflationary spiral. The western economies have also liberalized their international trade in a long, gradual process which began in 1947 and is still not complete. Unilateral trade liberalization can also be successfully introduced in a gradual manner, as Israel showed in the 1960s.[15] The important requirements of such policies is not so much that they are gradual but that they are credible: as long as everyone is confident that the government's course is feasible and will be maintained – a confidence which can be greatly strengthened by dated targets – then the signals for changing behaviour and re-allocating resources will begin to operate from the moment that the policy is implemented.

Those who advocate "shock therapy" appear to believe that it is possible to bring about a radical change in attitudes, expectations, and behaviour in a very short time. It is difficult to find much evidence for this. Many economists and most businessmen would probably agree with Alfred Marshall[16] that it is continuous, small incremental changes that keep the world moving: any large shock tends to increase (Keynesian) uncertainty and, thus, to paralyze action and propagate wait-and-see attitudes. This was evident, for example, not only with the large increases in oil prices in the 1970s but also with the large *fall* in the oil price in 1986.[17] "Big bangs" may also have a large and unexpected fallout which may be very costly: the protracted recession in the Scandinavian countries, the United Kingdom and, until recently, the United States, is to a significant degree an unforeseen consequence of the rapid deregulation of financial markets in the 1980s.[18]

What does not seem to be widely appreciated is that in democratic societies "big bang" policies are the rare exceptions rather than the rule. The general tendency is instead to "gradualize" as many adjustment problems as possible. Western governments normally pursue macroeconomic adjustment within medium-term programmes of targets for controlling monetary aggregates and reducing budget deficits, although even they can run into social resistance if meeting a specific target imposes too heavy costs on sections of the population (meeting the somewhat arbitrary Maastricht targets for economic convergence is creating such problems in some west European countries). Gradualism at the level of microeconomic adjustment is so common that it is hardly ever remarked upon. The completion of the European Community's single market by the end of 1992 was essentially a five-year programme of micro reforms intended to round off a process of structural change which had been under way for decades – and at the beginning of 1993 a number of objectives has still not been met. The introduction of noise limits on commercial aircraft, of catalytic converters on motor cars, and the phasing out of CFCs, are just a few of the thousands of other cases where governments seek to internalize or eliminate gradually specific externalities arising from private activity: those who suffer from the nuisance obviously want it removed as quickly as possible while the producer, who must bear the cost of its elimination, will want to postpone action for as long as possible. Bargaining takes place to reconcile these two positions and the outcome is usually an agreed date for the removal of the nuisance, not so soon as to impose too large a reduction in the producer's economically viable capital stock but not so distant as to make the policy incredible.[19] The results are not always optimal and there is always a danger that well-organized producer interests will have a disproportionate influence on the outcome. Nevertheless, the principle is clear that the nature and distribution of adjustment costs is a legitimate concern of democratic politics and, as a result, adjustments will tend to be gradual.[20]

In general, open democratic government must mean, among other things, adopting a pace of policy making which gives time for genuine discussion and for the electorate's fears and interests to be listened to and taken into account. This is a basic principle, but it

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of thermodynamics. A moment's reflection will show that none of these metaphors connect with the reality of the transition process and are therefore unable to illuminate it.

13 A common recommendation, especially from western and "international" advisers, is that eastern gov. ments should, for example, privatize "as quickly as possible". Such statements have little operational significance.

14 See United Nations Economic Commission for Europe, *Economic Survey of Europe in 1989-1990*, New York, 1990, pp.21-22.

15 A World Bank study of 17 countries (D. Papageorgiou, et al., *Liberalising Foreign Trade*, Blackwell, 1991, 7 volumes.) has concluded that a bold trade liberalization tends to be more sustainable than one which is staged. However, Professor Greenaway has criticized this study for making extravagant claims for the generality of its results and has pointed out that there is much greater diversity of experience in the 6 volumes of country studies than is conceded by the authors of the summary volume. See David Greenaway, "Liberalising Foreign Trade Through Rose Tinted Glasses", *The Economic Journal*, 103, (416), January 1993. See also, Dani Rodrick, "Closing the productivity gap: does trade liberalization really help?" in G.K. Helleiner (ed.), *Trade Policy, Liberalization and Development*, Oxford: Clarendon Press, 1992.

16 To emphasize the role of continuity in his analysis, Marshall chose the motto *natura non facit saltum* for the title page of his *Principles of Economics*, published in 1890.

17 See United Nations Economic Commission for Europe, *Economic Survey of Europe in 1986-1987*, New York, 1987, pp.14-18.

18 See section 2.1 below.

19 Thus, the Oil Pollution Act of August 1990 in the United States set a limit of 15 years to phase out single-hulled tankers using United States ports. Last December the EC agreed to advance its target date for the reduction of CFC use by 75 per cent to the end of 1993 and to phase it out entirely by 1996.

20 The economic adviser to the Indian Finance Minister has said that India's reform was going ahead "at a gradual pace" because "there was no other way of carrying out change *in a large democracy* such as India", (italics supplied). *Financial Times*, 6 November 1992

applies with special force in the transition countries where the issues for debate are not simply banausic economic details but fundamental questions about the structure of society and the nature of changes in the political and ethical values previously associated with collectivism. These countries are engaged not only in creating market economies but also in building democratic institutions and developing democratic practices for the resolution of conflicting interests. In theory it is possible to separate the economic and political programmes but in practice the two are inextricably intertwined. "Shock therapists" tend to ignore these questions: their approach tends, in effect if not by intention, to be autocratic and often arrogant in suggesting that "there is no alternative" to their proposals. On the contrary, there is always an alternative: that is what market economics and democratic politics are all about. But it is the job of the economic adviser to estimate the costs of the various alternatives so that responsible choices can be made by those who must either bear the costs directly or face the political consequences of underestimating them.

Somewhat curiously, "shock therapists" tend to be more worried about a reversion to the old command economy, or a diversion to some "third way" between the latter and the market, than the risk of losing popular support for the difficult transition to a market economy. This is surprising because the revolutions of 1989 in eastern Europe and the rejection of the coup plotters in 1991 in Russia clearly demonstrated a massive disdain for the old regimes and a strong will for democracy and the market economy – or, at least, to put it more prosaically, for an economy that works. The subsequent disillusionment and weakening support for the reforms (discussed below) reflects not so much a nostalgia for the past as disappointment at the level and duration of the costs of transition and, in particular, fear of unemployment and disquiet at what appears to be a highly uncertain future. But the policy response to this situation should not be obsessed with cutting off all possible retreat to the past but on maintaining a popular consensus behind a transparent programme to establish the market economy and democratic institutions.

The argument between shock therapists and gradualists diverts attention from the central issues of policy making for the transition. These are, first, to create a credible programme for the transition and second to create and maintain popular support for the duration of the programme. The two are related, of course.

Credibility has several dimensions. But the crucial ones involve the government being able to define a clear set of objectives, to demonstrate a clear understanding of what is required to reach them, and to convince economic agents and the electorate at large that the government possesses – or will soon acquire – the necessary economic instruments to implement its programmes.[21]

The drive towards the market economy, therefore, needs to be spelled out in terms of a series of intermediate objectives (institutional reforms etc.) and the inter-dependencies between them set out in a transparent and comprehensible manner. This is related to the issue of sequencing. The literature on sequencing highlights the fact that the probability of success in achieving a given objective may be increased by following one sequence of measures rather than another – in the worst case an incorrect sequencing would destroy all chance of success. The insight is a useful one but the theory does not provide operational formulae for policy makers in the transition economies.

In practice, "correct" sequencing will have to be a matter of pragmatic judgement, made in the light of each country's individual circumstances although there may exist a few general rules derived from experience. Thus, for example, the experience of some of the transition economies already suggests that it may be unwise to go for rapid price liberalization when the authorities do not possess effective instruments of monetary control. The existing literature on sequencing may also be misleading for the transition economies insofar as it suggests alternative, linear sequences of policy actions. The transition process, with economic and political programmes of reform inter-twined, is highly complex and will frequently require simultaneous action on a number of interdependent issues for significant progress to be made. The task is therefore to identify key sets of interdependencies which in turn would help to identify bunches or menus of reform[22] which should be given priority in the transition programme.

The need for simultaneous action on a number of fronts is of course one reason why some advisers propose a "big bang" or "shock therapy". However, needs and possibilities are not always congruent, and this advice overlooks the fact that different elements of the reform will have their own sub-sets of measures and may require very different periods of time for their implementation. This implies that the need is for the simultaneous *completion* of a set of reforms rather than a simultaneous *start* on them. It is perhaps not surprising that rapid price and trade liberalization have figured so prominently in the reform programmes recommended and adopted in the eastern countries because these are among the few reforms which *can* be implemented quickly. However, the results do not suggest that this was an obviously desirable step to have been taken.[23] Indeed rapid price and trade liberalization may be destabilizing in a transition economy with inelastic supply responses, which are partly due to institu-

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21 Credibility is not necessarily the same as determination. Determination without a coherent programme and effective instruments is mere bluster, while the determination of a government that has worked out a coherent programme and secured the necessary instruments for its implementation is self-evident.

22 An analogy with this problem is that of interdependent or complementary investment decisions. See, Hollis B. Chenery, "The Interdependence of Investment Decisions", in Moses Abramovitz et al., *The Allocation of Economic Resources*, Stanford, 1959 and Jan Tinbergen, *Development Planning*, London, 1967, chapter 7.

23 See Michael Bruno, "Stabilization and Reform in Eastern Europe. A Preliminary Evaluation", IMF, *Staff Papers*, vol.39, No.4, December 1992, p.752.

tional rigidities, and with inadequate instruments and institutions for creating and maintaining macroeconomic stability.

Perhaps the principal reason why many observers, including the authors of this *Survey*, are sceptical about the feasibility of a rapid advance to the market economy on "shock therapy" lines, is that the major part of the transition reforms consist of institutional and structural changes. This is not just a question of passing laws and creating new legal institutions but also of developing the informal codes and standards of behaviour, including managerial and business practices, which underpin the workings of all effective institutions. The institutional capital of a country also includes accumulation of skills and experience. Economists of the Austrian School, most prominently Ludwig von Mises and Friedrich von Hayek, are nowadays frequently quoted to explain the failures of central planning in eastern Europe and the former Soviet Union but are rarely invoked when the transition process is being discussed. Yet one of their key points is highly relevant to the attempt to construct a market economy: not only did they emphasize the primordial importance of the institutional infrastructure for the effective operation of the market but they also stressed the fact of the evolutionary development of institutions and behaviour over extended periods of time. Institutions in a legal sense can be easily replicated but the development of institutional effectiveness is a much slower process of learning and behavioural adaptation. Those who believe that the former centrally planned economies can be "shocked" into market economies would appear to have overlooked some of the most fundamental requirements for a market economy to function effectively.[24]

Many of these points congregate on the question of privatization. "Small" privatization (shops, services, small-scale enterprises, etc.) has developed rapidly and proved very popular in the countries which have implemented it. But the difficult problems arise with the privatization of the large – and by western standards, extremely large – state enterprises. In many respects "large" privatization (large state-owned enterprises) is the core of the restructuring problem and perhaps the most crucial stage in the transition to the market economy. But a rapid change of ownership of these enterprises will not automatically solve their problems or even assist in the creation of an efficient market economy. To sell such enterprises without restructuring them would undermine the creation of a competitive environment, although there are doubts that many of them would actually interest private buyers in their present state.[25] Questions of competitive structure, of effective corporate governance etc., all need to be settled before privatization takes place, otherwise the new private owners will probably resist any belated attempt to correct for market failure. A slower pace for "large" privatization, giving time for such questions to be settled as well as for the improvement of managerial skills and the adoption of commercial patterns of behaviour, may thus be more effective in achieving the ultimate objective of an efficient and sustainable market economy. The case for gradualism has been put very succinctly by the Prime Minister of the Czech Republic, Mr. Vaclav Klaus: asked whether he had plans to "speed up the privatization process" he replied that "privatization is a major social and multidimensional process. It cannot be speeded up. It is something which has its own dynamics and there are so many dimensions to it that I don't believe it can be accelerated."[26]

(v) Popular support for the transition process

The widespread and enthusiastic support for radical political and economic change that followed the revolutions of 1989 has now given way to a large measure of disillusionment and discontent as the costs of adjustment have proved to be much greater than expected.

Some of the reasons for this falling off in popular support were discussed in the previous section: a failure to construct coherent and transparent programmes for the transition and to accompany them with serious efforts to explain them to the electorates and to build a sustainable consensus in support of the reforms over the medium term. Expectations about the probable speed of reform – and of improvements in living standards – were greatly exaggerated at the end of 1989. At the same time, the stabilization policies adopted and the rapid introduction of price and trade liberalization, in the absence of adequate monetary and fiscal institutions and endemic microeconomic distortions, led to a much deeper and longer recession than any eastern political leader or policy adviser expected. Consequently, not only have expectations of improved living standards been rudely disappointed, but the costs of adjustment are so much greater than expected that living standards are perceived to have fallen sharply for large sections of the population. Growing resentment at this outcome is increased by the tendency of shock therapists, as well as many political leaders, to ignore the democratic requirement to explain and to allow time not only for discussion but also for people to adjust psychologically to the new orientations of economic and social policies.[27]

In Hungary, 4 million voters turned out in March 1990 for the first free elections in 40 years, but within

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24 See United Nations Economic Commission for Europe, *Economic Survey of Europe in 1989-1990*, New York, 1990, pp.22-23.

25 See section 3.6(viii) below.

26 *Financial Times*, 11 January 1993, in a special supplement sponsored by the Czech Ministry of Foreign Affairs. In the same interview Mr. Klaus also criticized those who mixed up the short-term and long-term dimensions of issues – "short-term gains may well be long-term losses and therefore we are wary of economic myopia".

27 That people usually take some time to recognize a radical change in their environment is often seen more clearly by non-economists. It " ... is not only a state of affairs, but a process of gradual realization. First one has to get used to the idea of it. The idea then has to become part of everyday life. Then rules can

6 months the Hungarian Democratic Forum (MDF) was losing by-elections on a 30 per cent turnout and in 1991 only 8 per cent of the electorate was bothering to participate in some by-elections. By the middle of 1992 opinion polls were recording widespread dissatisfaction with the economic (87 per cent) and political (72 per cent) situations.[28] A similar degree of discontent was apparent at the start of 1992 in Poland: 87 per cent were dissatisfied with the political situation and 80 per cent with their standard of living.[29] The Hungarians put most of the blame for their situation on their government, but rising economic and political dissatisfaction in Poland has been accompanied by falling confidence in most institutions, the police and the military being the principal exceptions.

Frustration is also considerable in Russia. In a poll of Russians in October 1992 only 5 per cent were satisfied with the economic situation, 16 per cent with their standard of living, and 10 per cent with the political situation.[30] Moreover, a large majority was dissatisfied with the political *system* and there is little enthusiasm for the main political leaders. Only the church and the military received majority approval from those polled. These results do not necessarily imply that Russians are indifferent to efforts to introduce more democratic ways of government, to extend the domain of civil society, to develop an independent and objective media network, and so on. Earlier polls indicate significant support for these objectives, although there is a large proportion of people with little understanding of the points at issue – the "don't knows". However, the grinding costs of economic disruption and the impact of the January 1992 price liberalization appear to be behind the rapidly growing majority of Russians who would prefer greater social security to more political freedom. A majority of Russians face the prospects for 1993 with considerable trepidation.

Popular attitudes to specifically economic reforms are complex and often contradictory. In eastern Europe a majority of the population is by and large in favour of the market economy but when questions get closer to their personal situation the responses are more guarded. A succession of polls in Hungary suggested that while a majority supports the reform process, those who support privatization *and* are willing to accept the costs (in terms of unemployment and increased inequality of incomes) are in a minority which is getting smaller.[31] So-called "small" privatization is generally popular but there is considerable opposition to the transfer to private ownership of large enterprises, large estates and other items of wealth.[32] In April 1992 a majority of Hungarians supported the idea of a market economy, but only 35 per cent wanted an untrammelled market system, while a similar proportion wanted to preserve positive elements from the former system.[33] Similarly in Poland, only a small minority hankers after the old system of central planning, narrow wage differentials etc., but a large majority in January 1992 was in favour of retaining specific features of the former regime, the most prominent being the state welfare system (92 per cent) and full employment (82 per cent).[34] There is still a lot of resistance to privatization in Poland, especially among the workers, a majority of whom would prefer continued state ownership or some form of control by employees. Plans for a free distribution of stock in 400 large Polish enterprises was abandoned in early 1992 because of political opposition.

The most positive attitudes towards the market economy in general and privatization in particular are to be found in the Czech Republic, and such attitudes appear to have strengthened over the last two years, in contrast with developments in other east European countries. In Slovakia, however, there is much greater fear about the consequences of privatization and in 1992 this unease was a source of support for those parties promising a change in economic policies and a more moderate pace of privatization than in the Czech Republic.

The situation in east Germany is, of course, a special one, not least because of the considerable transfer payments from the western part of the country which have supported disposable incomes. According to one opinion poll only 15 per cent of east Germans considered themselves less well off in summer 1992 compared with their situation before unification and 42 per cent said they were better off. But the share of the population with a favourable opinion of the market economy dropped between the spring of 1990 and the summer of 1992 from 77 per cent to 44 per cent. The proportion of persons supporting the closure of non-viable firms has fallen and support for state intervention to restructure firms has increased. These changes in attitude appear to reflect the personal stress associated with systemic change, a perceived lack of personal security, and the sudden collapse of the former organization of private lives, which has led to considerable desorientation about the future.[35]

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change, rules of behaviour, of language, of expectations". The writer is actually referring to the approach of war in Croatia. See Slavenka Drakulic, *Balkan Express. Fragments from the Other Side of War*, London, Hutchinson, 1993, p.18.

28 Judith Pataki, "Hungarians dissatisfied with political changes", *RFE RL Research Report*, 6 November 1992, pp.66-70.

29 Michael Dess and Hill Chin, "Roundup: Life in Poland", *RFE RL Research Report*, 22 May 1992, pp.62-63.

30 Mark Rhodes, "Political Attitudes in Russia", *RFE RL Research Report*, 15 January 1993.

31 E. Hann and M. Laki, "The Hungarian Public on the Advance of Private Economy", *Acta Oeconomica*, 44 (1-2), 1992, pp.191-200.

32 Loc.cit.

33 Yudit Kiss, "Privatization in Hungary – Two years later", *Soviet Studies*, 44(6), 1992, pp.1015-1038.

34 Michael Dess and Jill Chin, loc.cit.

35 See Renate Köcher, "Die Ostdeutschen fröstein in der Freiheit", *Frankfurter Allgemeine Zeitung*, 9 September 1992.

What conclusions can be drawn from such surveys of public opinion? The contradictions and qualifications surrounding general statements of support for the market system should not be surprising to those familiar with the western market economies: voters have frequently and notoriously voted simultaneously in favour of increased public expenditure while resisting any increase in taxes; they may also support government programmes to restructure national industries but oppose any change in their own, especially if their own jobs are at risk. The eastern electorates are just as contradictory: at one level they complain that there is too much change while at another they object that there is too little (often when they see familiar faces from the old *nomenklatura* still occupying positions of power and influence). For the individual, actual or imminent private cost will nearly always loom larger in his or her calculations than any notional social benefit. The problem of overcoming such resistance was recognized a long time ago. When Macchiavelli declared that " ... there is nothing more difficult to take in hand, more perilous to conduct, or more uncertain in its success than to take the lead in the introduction of a new order of things",[36] he identified two reasons for failure: first, the determined resistance of those benefiting from the status quo and, second, the lukewarm support from those who stood to benefit from the reform. The latter's pusillanimity was due in part to fear of the former's hostility but also to uncertainty about the outcome, "men ... never really trusting new things unless they have tested them by experience".[37]

In modern political economy the frustration of socially desirable reforms is most often explained by the potential losers, those with an interest in the *status quo*, being able either to out-vote the potential gainers, or to out-manoeuvre them through superior lobbying power.[38] However, neither of these possibilities appears to fit the situation in the transition economies. The status quo, to a large extent, has already lost the vote in favour of reform in general and, anyway, those who did *well* under the old system appear to be doing well under the new. So why should an increasing majority in the eastern countries be reluctant to support the specific measures of reform which, it believes, will benefit the population and the economy as a whole? A recent attempt to answer this question[39] focuses on the *ex ante* uncertainty concerning the distribution of *individual* costs and benefits: if *individuals* are uncertain as to whether *they* will benefit from a reform, there may be a bias against the change even if it is certain that the majority will benefit. Individual uncertainty can therefore distort the aggregate vote – the majority might vote against itself.[40]

Creating and maintaining support for the transition

How should governments respond to the ambiguous and weakening support for the transition, as described above? One response might be to dismiss the evidence, either as being inaccurate, a common retort of politicians when the results are not congenial, or as an inevitable short-run reaction to the initial costs of otherwise sound policies. In both cases the recommendation would be to push ahead with the chosen policy and, in the second case, patiently wait for the return of public support when the promised benefits of the policies begin to appear. The analysis of individuals' *ex ante* uncertainty, referred to above, might appear to justify such a course. However, there are a number of difficulties with this response, especially in the context of the transition countries. One is the scale and complexity of the reforms being undertaken, more or less simultaneously, which ensure that a large majority of the population will be adversely affected by the changes in the short run – and the potential resistance is therefore very large. Another is the considerable uncertainty surrounding the time required to produce the promised benefits – there is a good chance that they will arrive too late to save the government from electoral defeat. The prospect of the latter will, in turn, be an incentive to abort or weaken the reform. Finally, the data given above indicate that there is already a widespread loss of patience with government leaders and, presumably, less willingness to take at face value the promises and predictions of policy makers. The governments of the transition economies are therefore unlikely to succeed by simply "charging on". Instead they will have to secure a large and broad-based measure of popular support if the transition to the market economy is to be achieved within a framework of democratic institutions.[41]

However, not the least of the problems in most of eastern Europe and the former Soviet Union is that political leaders and policy makers have invested few resources into building up a national consensus behind well articulated *programmes* of reform. As was remarked in this *Survey* three years ago,[42] the objective of creating a market economy is a general statement of principle which is vague both about the precise nature of the objective and the route to achieve it. It is there-

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36 Niccolò Macchiavelli, *The Prince*, Penguin Books, 1961, chapter VI, p.51.

37 Ibid.

38 The second possibility may in turn derive from an asymmetry in the distribution of costs and benefits, a situation which is often used to explain the persistence of import restrictions whose removal would produce a net social benefit.

39 Raquel Fernandez and Dani Rodrik, "Resistance to Reform: Status Quo Bias in the Presence of Individual-Specific Uncertainty", *The American Economic Review*, 81 (5), December 1991, pp.1146-1155.

40 *Ex ante* hostility to reforms can therefore quickly change to *ex post* support once they have been "tested by experience" and seen to work. Fernandez and Rodrik, loc.cit, p.1154, point out that radical trade reforms introduced by autocratic regimes in the face of opposition or little support have subsequently proved to be popular. The examples they give are South Korea (early 1960s), Chile (1970s) and Turkey (early 1980s).

41 Machiavelli, of course, was not impressed by the efficacy of persuasion and thought that force was the more effective instrument for changing the order of things.

42 United Nations Economic Commission for Europe, *Economic Survey of Europe in 1989-1990*, New York, 1990, pp.14-15.

fore not very difficult for opinion polls to find considerable support "for the market economy", although, even at this level of generality, majority support appears to be lacking in Russia and other former republics of the Soviet Union.[43] The difficult task is to draw up a programme of action in which all the component parts are clearly related, in which a realistic timetable for achievement is set out, and where estimates of the inevitable costs are laid out together with policies to attenuate their impact on specific groups in society. That done, the programme must be explained and "sold" to the electorates if the required consensus for each stage of the reform is to be created. Hardly anything of this sort has been carried out systematically in the transition economies.[44]

Instead, government policies often appear to be characterized by a large measure of improvisation and by series of ad hoc measures which may or may not be coherent. Moreover, communication with electorates has been hampered by the lack of broadly-based parties in most of the transition economies and in many cases by weak news media. Parliaments are also, for the most part, composed of myriads of small parties supporting inevitably fragile coalition governments, which tend to be subject to a constant barrage of conflicting criticism from within and without the ranks of the government. It is thus perhaps not very surprising that popular support for the details of reform has been weakening. In the middle of last year over half of Hungarians felt that their government was not very close to the people and that the distance was increasing.[45] In Russia, where a number of radical changes were introduced last year, there was virtually no attempt by the Government to launch a propaganda campaign to explain and gather popular support for the Gaidar programme. The contrast with the recent efforts of the President of the United States to explain and build support for *his* economic programme could not be more stark.

It was the fashion in a few western countries in the 1980s to deride the notion of consensus since, it was claimed, the search for it was an obstacle to action by governments and rulers who knew best what to do. Such an autocratic approach may be sustained for a while if governments have large parliamentary majorities and are subject to few constitutional restraints by the legislature. But it is difficult to see how the transition process can be sustained in emerging (or re-emerging) democracies without a large and sustained measure of popular approval. A consensus has to be created and maintained to carry out the programme of reform over a fairly long period and, almost certainly, beyond the life of the government that initiates it.

The need for consensus on a coherent programme for transition is essential because, as mentioned already, many of the institutional changes which constitute the building blocks of the entire process are not details which can be left to economic technicians but matters which will influence the type of market economy and, indeed, the nature of the society that will emerge at the end of the process. Means and ends cannot be easily separated when the objective is a radical systemic change. Consensus on the institutional structure of the market economy is thus important for future societal stability because it will help to underpin the removal of ideology from day-to-day economic decision-making. But it will also help to insulate the institutions of civil society from the transitory popularity of individual governments.[46]

Another reason for eastern policy makers to pay much more attention to explaining and "selling" their programmes for economic reform in a broader institutional and social framework is the widespread anxiety and disorientation in the eastern countries that many observers report. This refers not only to economic security but also to the ennui associated with a collapse of settled values and patterns of behaviour, as well as the problems of "identity" that arise when states break up and ethnic tensions are revived. The scale of these problems vary considerably, of course: they seem to be marginal in the Czech Republic but considerable in Russia and the former German Democratic Republic. Probably most periods of rapid systemic change give rise simultaneously to raised expectations and to widespread anxiety, and so the apparent contradiction between a majority being both in favour of rapid change and of wanting to hold it back is not surprising. But that is the point where governments must provide a vision of the way ahead and a credible set of policies for moving forward. A distinguished French historian has argued that "the attitudes of individuals and groups of individuals to their own situation in society and the conduct these attitudes dictate are determined not so much by actual conditions as by the image in the minds of the individuals and groups".[47] It is the task of the policy maker and, above all, of the political leader, to alter that "image" in such a way as to support the dynamics of the transition process and the building of a democratic, market-based society. Failure in this regard will not only compromise the transition but is likely to enlarge the constituency for ethnic chauvinism and other outlets for frustrated expectations and unrelieved anxieties.

The difficulties facing the governments of the transition economies are considerable and building a consensus for the transition is essentially a task for national

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43 See above, and also, Commission of the European Communities, *Central and Eastern Eurobarometer*, Brussels, February 1993.

44 There was, of course, the Balcerowicz Plan for Poland in January 1990 and the four-year Kupa programme for Hungary in February 1991, but the former was inevitably dominated by the severe stabilization problems facing Poland at the end of 1989 and the latter was largely a set of macroeconomic targets rather than an articulated programme of action. The Czechoslovak *Scenario for Economic Reform* (1990) corresponds most closely to the suggestion made here.

45 Judith Pataki, loc.cit., p.67.

46 This is not to say that institutional questions can be removed from politics, only that the prospects for stability are greatly strengthened if most of the people have confidence in most of their institutions most of the time.

47 George Duby, quoted in Linda Colley, *Britons: Forging the Nation 1707-1837*, Yale University Press, 1992, p.43.

politics. But insofar as western governments and the international financial institutions have some influence through the provision of financial and technical assistance, they can encourage the preparation of transparent programmes of structural change and, following the example of the Marshall Planners, even make them part of the conditionality of aid. Specialized technical assistance in this area can also be very useful.[48] However, one important step would be for western and international donors to insist on discussing programmes not only with governments but also with opposition parties and other social groups. In this regard, the excessive confidentiality which frequently surrounds governments' discussions with the Bretton Woods institutions[49] is counter-productive: not only does it encourage many unfounded allegations about these institutions *and* western governments, but no-one has ever demonstrated that a lack of openness improves the quality of economic policy making. Greater transparency is also desirable within the transition countries, especially on issues such as the privatization of state enterprises.

The role of safety nets

Despite the manifest economic and political failures of the former communist regimes and, in eastern Europe, their association with Soviet hegemony, it would be wrong to assume that the populations of these countries have rejected every single aspect of the former system. The opinion surveys discussed above are clear, that while rejecting central planning and all its coercive features, a significant proportion of the population in eastern Europe wishes to retain what it regards as positive elements of the previous system, notably its provision for welfare and job security.[50] This possibly reflects a more egalitarian preference than is the case among west Europeans, who in turn tend to be less tolerant of large income differences and more welfare-minded than Americans. However, it is more likely that the main reason is the anxiety referred to already and the real fear not only of losing one's job but of not being able to function adequately in the more competitive environment of the prospective market economy. It is clear from the opinion surveys that support for the reform process and for privatization is strongest among the young, the better educated, and the better off; and that fear of reform and resistance to privatization is greatest among the workers, especially in large state enterprises, the less educated and those at the bottom of the income scale. The task of policy is therefore to ensure that the energy of the first group is not frustrated by the fears of the second.

Clearly, not all of the perceived "positive elements" of the former system can be retained in the transition process: some of them are simply inconsistent with a market economy, while the scale on which welfare was previously provided is probably impossible to maintain without putting intolerable strain on general government budgets. Nevertheless, an effective safety net does have to be in place if the reform process is not to be blocked by those who think they might lose. So far this has not been a major issue, but it seems likely to become so as the major hurdle of privatizing the large state enterprises is approached.

The reorganization and, in some cases, reconstruction of social safety nets involves a number of detailed issues but two points can be stressed here. One is that safety nets cover a wide range of situations of which unemployment is only one – from the perspective of minimizing interference with labour market incentives, unemployment benefit should be clearly separated from other types of benefit.[51] Secondly, insofar as many welfare functions in the centrally planned economy were carried out by enterprises, especially in the states of the former Soviet Union, the reorganization of welfare systems is closely connected with the restructuring of state enterprises: before the latter are privatized the former will need to be nationalized.

In preparing to cope with the social consequences of "large" privatization, one of the first steps for government to take is to make some estimate of the distributional impact of market reform on individual industries and enterprises. Some work has already been done which, for some countries, should help to identify the extent to which particular sectors will be "shocked" by the onset of market pressures.[52] Such estimates will not only provide a guide to the likely scale of government expenditure on unemployment benefits but, just as important, will indicate the priority areas for retraining programmes and other forms of adjustment assistance aimed at integrating workers into the market economy. The emphasis should be on augmenting human capital rather than the preservation of redundant physical capacities. As "large" privatization proceeds, this should be reflected by a falling share of enterprise subsidies in public expenditure and a rising share for active labour market policies.

Placing retraining in the context of the social safety net emphasizes the need for an integrated set of policies designed to assist the process of structural adjustment rather than just provide a static net to catch the casualties. Coordinating safety net and active labour-

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48 For example, the BBC has helped Radio Russia to produce a 26-part radio serial on "The Free Market Economy" and Radio Free Europe has produced a series on democracy and other subjects, sometimes in response to specific requests from eastern governments.

49 However secrecy is not just a problem with these institutions. The European Parliament complained last year about the secrecy which surrounded the Commission's negotiations on the Association Agreements with Czechoslovakia, Hungary and Poland.

50 An opinion poll carried out in April 1991 asked the question "What kind of a society should be built in the Russian Federation?". Twenty nine per cent of Russians answered "socialism", 3 per cent "capitalism" and 56 per cent "a society combining the best features of both social orders", *Izvestiya*, 24 April 1991, p.1.

51 See below section 3.2(i).

52 See, for example, Gordon Hughes and Paul Hare, "Industrial Policy and Restructuring Eastern Europe", Centre for Economic Policy Research, *Discussion Paper Series No.653*, London, March 1992.

market policies in coherent programmes of industrial restructuring should make it easier to attract western financial assistance to ease the pressures on the pace of government deficit reduction and would provide a sharper focus and a clearer set of priorities for foreign technical assistance. But this also raises the larger issue of industrial policy.

(vi) Industrial policy

In the 1980s there was a widespread reaction in western Europe and North America against the idea that the state had a major role to play in the running of the economy. Some of the critics were extreme, virtually claiming that state intervention could never do good and would invariably do harm. Behind the polemics was a serious argument about the feasibility of effective fiscal policy which had its roots in the macroeconomic failures of the 1970s. The conclusion of this, often bitter, debate appears to be that Keynesian intervention in the economy *can* influence the level of activity but the constraints on such action are much greater than in the 1950s and 1960s.[53]

Parallel with the attacks on Keynesian macroeconomics was a similar assault on the efficiency of government industrial policies, whether targeted at whole sectors or individual enterprises. This attack was also a mixture of polemics and serious debate. The traditional case for state intervention rested on the belief that it was capable of correcting a range of market imperfections. The principal ones are (a) positive or negative externalities which would lead to sub-optimal or excessive levels of investment in the activities which generated them; (b) the presence of economies of scale which might lead to reductions in competition and even monopoly; and (c) imperfections in financial markets which might lead to sub-optimal investment in risky or very long-term projects.

The intellectual attack on industrial policy was rooted in the theory of rent-seeking[54] and the economics of bureaucracy. State intervention will anyway tend to create distortions (by increasing taxes to pay for its intervention), but the political economy of rent-seeking emphasizes the diversion of resources into lobbying and other activities designed to influence government action in favour of one group of producers or another. Bureaucrats may then be fooled or overwhelmed by the arguments and pressures of sectional interests, or they may even ally with them in order to increase their own budgets and power.

Again, the conclusion of the argument was not to deny a role for state intervention but to underline the need to assess the costs more carefully and comprehensively and to be on guard against the distortionary effects of rent-seekers and bureaucratic empire builders. It also warns against the facile assumption that market failure can always be turned into government success. Measures to overcome such problems might include a clear institutional framework for conducting policy, an insistence on detailed and transparent programmes, and provision for effective parliamentary scrutiny and independent auditing. These, it will be recalled, are among the desirable characteristics of the programme for transition suggested as necessary in the previous sections.

The recent renewal of interest in industrial policy in western Europe and, especially, in the United States is much more focused on the externalities that might encourage economic growth rather than on the spotting of "winners" or "national champions" in specific industries or products. In particular, positive externalities are believed to exist in business investment, especially in machinery and equipment;[55] in public infrastructure investment which can raise the productivity and rate of return of private investment[56] (a "crowding-in" effect); in research and development; and in education and training (or human capital investment). This analysis leads to policy recommendations which include tax relief (or subsidies) on fixed investment and saving, subsidies and increased expenditure on education and training, and tax credits for research and development. The new United States Administration's plan to promote technology and growth includes proposals for (i) a network of manufacturing "extension services" to encourage a more rapid diffusion of new technologies and management techniques among small and medium-sized enterprises and (ii) the creation of regional networks of companies and research institutes which could cooperate in developing new products and markets. Some of these proposals have already been implemented in western Europe (see below).

Many of these ideas and proposals are relevant to the problems of industrial structure and regeneration facing the eastern transition economies. Western experience in this domain, especially at the regional level in western Europe, could prove to be a rich source of relevant technical assistance and provide a basis for future cooperation. However, to be effective, both industrial policy and technical assistance from abroad need to be coordinated within a broad framework in which the government sets out its ideas on the broad sectoral composition of output (high tech versus heavy industry), desirable market structures (competition policy), and the scale of capital spending required including

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53 This conclusion emerges from a large body of empirical research which showed that Ricardian equivalence was not perfect in practice. Another constraint on *national* fiscal policy arises from the greater openness and interdependence among the industrial economies. This suggests that the scope for fiscal policy will be greater if there is coordination among the major economies. See, G.D.N. Worswick, "The Scope for Macroeconomic Policy to Alleviate Unemployment in Western Europe", United Nations Economic Commission for Europe, *Discussion Papers*, Vol.2 (1992), No.3.

54 For a collection of papers on this see J.M. Buchanan, R.D. Tollison and D. Tullock (eds.), *Towards a Theory of the Rent-Seeking Society*, Texas A and M University Press, 1980.

55 See J. Bradford De Long and Lawrence H. Summers, "Equipment Investment and Economic Growth: How Strong Is The Nexus?", *Brookings Papers on Economic Activity*, 2:1992, pp.157-211.

56 See Alicia H. Munnell, "Infrastructure Investment and Economic Growth", *Journal of Economic Perspectives*, Volume 6, No.4, Fall 1992, pp.189-198.

public infrastructure investment. Again, one returns to the need for coherent and transparent programmes as part of the effort to build efficient market economies.

The spirit of the new approach to industrial policy is caught in a comment by Nobel Laureate James Meade, whose commitment to the market economy is unquestioned: " ... the price mechanism is the worst possible form of economic system except the others ... *Two hearty cheers for the Price Mechanism*".[57] However, many policy advisers to the transition economies are hesitant – and some are hostile to – about the whole idea of industrial policy. To some extent this reflects an extrapolation of ideas from a number of countries in the west in the 1980s when the emphasis was on deregulation and the removal of obstacles to competition. However that experience, the removal of marginal frictions in otherwise predominantly market economies, is not very relevant to the current problems facing the east. Moreover, this hostile attitude tends to obscure the fact that the transition economies have already been forced into adopting industrial policies *de facto* and, even, *force majeure*.

A purely free market approach to restructuring is attractive in that it would avoid too much reliance on the state bureaucracy which many people in the transition economies either distrust or judge to be incompetent to carry out an effective industrial policy. However, such an approach is probably impossible to follow in that many enterprises would probably find no buyers in their present state while the alternative of a massive jump in unemployment would be politically unacceptable. Moreover, as noted already, there is a strong case for breaking up the large SOEs before privatization in order to ensure competitive market structures in the longer term.

Consequently, many eastern governments and their bureaucracies are already involved in trying to identify which enterprises – or parts of conglomerates – could survive in the market without any government help, those which could survive after a period of "care and restoration", and those which should be liquidated as soon as possible. This is proving to be a difficult task. The problems include bureaucratic rivalries, limited managerial competence in assessing the potential viability of enterprises in a market environment, the politicization of the selection process for deciding which enterprises should survive or be liquidated, shortages of good managers, and so on. There are no easy solutions, no "big bangs" on the agenda, as is shown by the experience of Poland which, since 1989, has experimented with six types of industrial policy in an attempt to overcome a variety of problems, such as those mentioned above, and to reconcile a number of conflicting problems and interests.[58] In Germany the *Treuhand* has also been forced into the active management of the reconstruction of east German industry. Fears of regional de-industrialization have led the Federal Government to support Treuhand policies to preserve a core of local industrial activities.[59]

One approach to industrial policy, which has had considerable success in western Europe, is the development of regional partnerships between enterprises, business associations, and the local or regional government. If the local government is large enough to be responsible for economic strategy and major infrastructure investment within its region, powerful mechanisms can be set up for promoting regional development and providing effective support services for individual businesses.[60] Among the key conditions for success in such regional schemes are the creation of a vision of future development behind which a consensus can be created of all the interested parties; the need for the involvement of all concerned in the drawing up of strategic plans; the use of formal (business) planning techniques to define strategies clearly; and the direction of effort towards a few key goals based on a realistic assessment of available resources.[61] These requirements are clearly very similar to those suggested in the previous sections for the broader programmes of transition.

However, at present, most of the transition economies are grappling with a considerable array of problems which, as the Polish experience suggests, could easily end in policy grid-lock. These are precisely the circumstances where an appropriate amount of well-targeted and timely assistance from abroad could make a considerable difference to the chances of success or failure.

The above discussion suggests a number of obvious targets for foreign assistance which could directly ease the problems of industrial restructuring. However, it would be a mistake to focus only on industrial or micro-targets. In the discussion of "shock therapy" above, it was suggested that rapid price liberalization might be a very risky policy if effective fiscal and monetary institutions were not in place. In fact, fiscal and monetary instruments in most of the transition economies are still very imperfect. On the one hand, tax collection systems are being created but they are still a long way from being comparable to those in western Europe. The burden of adjusting government budget deficits therefore falls almost entirely on expenditure. On the other hand, monetary policy is not very effective in controlling private sector behaviour when the commercial banking system is still rudimentary and when

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57 J.E. Meade, *The Intelligent Radical's Guide to Economic Policy*, London: Allen and Unwin, 1975, p.123.

58 For a most useful account of these policies and the pressures which drove the government from one to another, see Ben Slay, "Evolution of Industrial Policy in Poland since 1989", *RFE/RL Research Report*, Vol.2, No.2, 8 January 1993.

59 Large-scale, regional industrial decline tends to meet considerable political and social resistance in democratic societies. On this point see Martin Bangemann, *Mut zum Dialog*, Bonn, 1992, p.20.

60 For a succinct survey of four highly successful programmes of this type (Catalonia, Lombardia, Limburg and Hamburg) see Coopers and Lybrand, *Lessons from Continental Europe: Promoting Partnership for Local Economic Development and Business Support in the UK*, Business in the Community, London, 1992.

61 Ibid., p.19.

high levels of inter-enterprise debt allow most state enterprises to escape from the reach of the monetary authorities. However, the one point in the economy where the monetary authorities can be relatively effective is in deciding whether or not to finance the government deficit. Consequently the entire burden of macro stabilization policy falls largely on government expenditure. This is obviously a very dangerous tendency because, if it is allowed to continue, the resources for expenditure on social safety nets will be diminished just at the moment when the need for them is going to increase considerably. There will also be little chance of getting a long-term programme of public infrastructure investment under way which is needed to encourage a revival of private investment and thus a restructuring of productive capacities. Instead, the further cut in demand is likely to deepen or prolong the recession, discourage private investment (both domestic and foreign) and to make it even more difficult for governments to resolve the dilemmas of industrial restructuring. Moreover, in some eastern countries further reductions in public expenditure will become increasingly difficult in the face of rising unemployment and growing popular resistance to more cuts in social programmes.

The appropriate targets for foreign assistance should therefore include the public sector. Foreign grants and loans would not only remove a growing constraint on infrastructure investment and restructuring but would also help to dampen the inflationary consequences of deficits as well as boosting reserves of hard currency. They would also help to contain growing discontent and potential opposition to the transition process. However, for assistance to be targeted, targets must first be selected: and for assistance to be effective the targets must be coherently related in a clearly articulated programme. The continuation of aid for any reasonable time will only be likely if it is made contingent on agreed conditions and targets being met. These can best be specified in such a programme: the conditions need not be too rigid – as long as the transition process is kept on course the aid will be well spent.

(vii) Western support for the transition process

The basic strategy envisaged by western governments for assisting the eastern countries in their transition to decentralized market economies was for an initial burst of technical assistance, backed up by improved market access for eastern exports to western markets and by IMF short-run financing, which, it was hoped, would open up the way for private investment to take over the basic task of economic re-structuring. Technical assistance was needed to help in the creation of the institutional structures of a market economy and in training people to operate it effectively. Without such assistance it was thought that the capacity of the former centrally planned economies to absorb financial aid and attract foreign private investment would be limited. There was – and remains – considerable agreement on the need for such technical assistance. However, the ECE secretariat, in one of the earliest analyses of the subject, stressed that the relative *proportions* of technical assistance and financial aid to the eastern countries should be the reverse of those in the Marshall Plan which was "long on grant aid and short on technical assistance".[62] There was no suggestion that grant aid and credits were not important and a number of priority areas for such help, such as infrastructure investments, were suggested.[63] In addition, it was stressed that assistance would be most effective if, following the Marshall Plan model, it was targeted within coherent programmes of adjustment drawn up by the recipients themselves. The need was also identified for an overall coordinating function to be entrusted to an international institution which would help to clarify the needs for assistance, monitor progress and provide a forum for the exchange of ideas and experience.[64]

If an attempt is made to assess the assistance effort in the light of these suggestions, the conclusions are very mixed.

The first point to stress is that it is virtually impossible to obtain a clear cut, statistical picture of current assistance efforts. The "large" numbers which are frequently quoted in the press are usually commitments (of various degrees of strength and often tied to purchases from specific countries), and usually refer to a cumulative total since 1989 or 1990. Concessionary loans are mixed up with bilateral and other credits at market rates of interest, and commentators may or may not include estimates of the value of debt re-scheduling in the numbers they quote.[65] The OECD maintains a data bank on financial flows, including development assistance to eastern Europe and was also asked by the 1992 Washington and Lisbon Conferences to provide an information clearing house on requests for and offers of assistance to the CIS. However, the information provided by donors is neither complete, timely nor, in some cases, arranged in accordance with standard definitions of assistance. The latest available estimates of total gross financial flows, including genuine aid (i.e., grants and concessionary finance), are for 1990.

The reasons for this state of affairs are not very clear. To some extent they may simply represent the teething problems of organizing a new monitoring capability covering a large number of donors. The number of ministries and institutions involved in assistance within individual donor countries is also larger than those normally concerned with development assistance and this too complicates and delays the reporting to international institutions. But there is also an element of competition among donors to support the most

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62 See United Nations Economic Commission for Europe, *Economic Survey of Europe in 1989-1990*, New York, 1990, p.15.

63 Loc.cit., p.24.

64 See below, chapter 4 for a discussion of some of these problems and a presentation of the available data.

65 See below, section 4.2.

prestigious projects and those with spin-offs for their own exporters – and this may tend to slow down the provision of timely data.

But whatever the reasons may be, if the basic function of monitoring is still in such a rudimentary state, it is hardly surprising that there has been growing criticism at the lack of international coordination of assistance to the transition economies.[66]

Poor monitoring does not simply undermine effective coordination among donors but can lead to unnecessary acrimony between donors and recipients. An example of this is the controversy over how much of the G-7 $24 billion aid package for Russia, announced on 1 April 1992, was actually delivered. Estimates have ranged from $8.5 billion to more than $24 billion, while the Managing Director of the IMF has stated that the G-7 obligation was "essentially" met.[67] Part of the argument arises from the protagonists referring to different parts of the package[68] but there still seems to be large differences in the numbers quoted for bilateral credits. It is very difficult to sort all this out when the data come from a variety of sources, not all of them easily accessible or referring to the same period of time. These are not inconsequential squabbles among economists. A large discrepancy between what is claimed to have been given and what is asserted to have been received could lead to a deterioration in a country's standing in relation to its creditors and so affect the flow of future finance. Disagreement may also damage the credibility of western donors in the eyes of the eastern electorates whose continued support for the transition programmes is essential for their success.

Donor credibility is also at risk from the increasing tendency to refer to virtually all financial flows to the transition countries, from outright grants to loans at market rates of interest, as "assistance". Credibility is stretched even further when such an aggregate is favourably compared to the scale of Marshall Aid which in fact was largely composed of grants.

An accurate monitoring of the levels and composition of financial flows to the transition economies is therefore urgently needed as an essential step in improving coordination among the providers of assistance.

In the area of technical assistance there is no doubt that a considerable amount of activity is under way and that it has expanded rapidly in the last two years. The European Community runs a large programme and there are important national efforts. Obviously it is very difficult to assess the economic impact of such assistance: it cannot be easily quantified, except as lists of projects, and the effects are often diffused in ways which are also difficult to measure. Anecdotal evidence suggests that a lot of this assistance is proving to be very useful but, as the programmes have grown they too have been subject to the criticism of poor coordination among donors and questions have been raised about their cost in relation to their presumed benefit to the recipient countries.[69]

One of the most important aspects of the coordination of assistance is matching it with the needs of the transition economies. This does not mean financing any good project that happens to be presented to the donors but of identifying the key areas and problems which are constraining the development of private sector activity and the growth of the market economy. The increasing references to "well-targeted" aid, especially in relation to the problems in Russia, suggest that donor governments are preparing to put greater emphasis on this. Nevertheless, as noted above in the context of industrial policy, an efficient selection of targets is difficult without a broader framework for the transition in each country. One way of providing such a framework is to follow the example of the Marshall Plan in insisting that the recipient countries draw up their own assessment of their needs within a 5-10 year programme.[70] (Some of the poorer transition economies may need assistance to do this in order to avoid being left out in the distribution of resources.)

As for the actual flows of financial resources to the transition countries, not a great deal can be added at the present time to the picture presented in the last edition of the *Economic Bulletin for Europe*,[71] (for the reasons noted above).

The hopes for large inflows of *private foreign capital* to the transition economies have still not materialized for most of the countries concerned. Net inflows of foreign direct investment *have* risen, from about $0.6 billion in 1990 to just under $3 billion last year.[72] This is an encouraging improvement, but the amounts involved are still very small in relation to the $28 billion or so flowing to developing countries and world-wide

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66 See the comments of the United States Treasury Secretary, Mr. Brady, at the 1992 annual meeting of the EBRD (*Financial Times*, London, 13 April 1992). Also, United States General Accounting Office, *Former Soviet Union Assistance by the United States and Other Donors*, Washington, D.C., December 1992.

67 IMF, *Survey*, Washington, D.C., 22 February 1993.

68 Mr. Camdessus said "... frankly, there has always been confusion about the composition of the package", ibid.

69 On the EC programmes of assistance see the Court of Auditors, "Annual report concerning the financial year 1991 together with the institution's replies", *Official Journal of the European Communities*, C330, vol.35, 15 December 1992. The OECD has also criticized western technical assistance to the former Soviet Union for its relative neglect of certain sectors and for an unbalanced distribution between individual republics. *Financial Times*, 14 October 1992. (This latter report does not appear to be publicly available.)

70 This point has been frequently stressed in previous issues of this *Economic Survey of Europe* and the *Economic Bulletin for Europe*.

71 United Nations Economic Commission for Europe, *Economic Bulletin for Europe*, vol.44(1992), New York, 1993.

72 Newspaper reports often give much larger figures than these, but the statistics for FDI are frequently subject to the same confusions as those noted above for financial assistance. Announcement of projects and intentions to invest may refer to an aggregate to be spread over several years and, for various reasons, the actual investment may be much less than originally announced. The above figures are also a balance of payments cash, not accrual, basis. See below, section 4.2.

flows of some $200 billion."[73] Moreover, the bulk of foreign direct investment (some 90 per cent) is concentrated in Hungary and the Czech Republic. FDI also increased in 1992 in Poland and Slovenia although the amounts still remain relatively small.

Hungary and the former Czechoslovakia are also the only transition countries which were able to borrow significant amounts over the last three years on the international capital markets.

The outlook for foreign private investment in the eastern countries remains uncertain. The well-known deterrents to investment include political uncertainties, which are considerable in some countries, incomplete market infrastructures and delays in resolving basic problems such as property rights. The much delayed recovery of activity in the eastern economies together with a deepening recession in western Europe, has led to western companies re-assessing their investments in the east and to an increasing tendency to postpone new investments.

Thus, most of the transition economies are dependent for outside funds on official "assistance", bilateral and multilateral, and government-guaranteed bilateral credits. As was emphasized above, it is extremely difficult to make a reliable estimate of the total flow of these resources – reporting is inadequate and some institutions are hesitant about releasing data on annual disbursements as opposed to cumulative commitments. The ECE secretariat has estimated that the aggregate flow to eastern Europe in 1991 was probably of the order of $20 billion."[74] For 1992, there appears to have been a fall in multilateral financing, from some $8.5 billion to less than $5 billion, with special financing (debt write-offs, re-scheduling, deferrals and arrears) accounting for another $5 billion or so in 1992. There is great uncertainty over what happened to officially guaranteed bilateral credits, so it is difficult to say whether the total funds available to eastern Europe increased or not last year.

In addition to these funds, the countries of the former Soviet Union received some $14 billion in special financing and Russia received perhaps $12 billion in bilateral credits and a further $1 billion from the IMF.

Altogether, perhaps some $40 billion or so of financing was made available to all the transition countries last year. Again, the uncertainty surrounding these figures must be emphasized: It should also be underlined that only a small proportion of this money consists of grant aid or concessionary finance as defined by the OECD's Development Assistance Committee. Bilateral credits are debt creating and carry market rates of interest. About one half of the above total is accounted for by debt rescheduling and other forms of "special financing". This gives important short-term relief, but of course the debt and the obligation to service it remains. Also, given the importance of conditionality, it should be noted that very little of the finance made available is directly focused on and integrated with specific programmes of reform. Finally, the numbers quoted here should be seen in the perspective at the scale of *net* government transfers from the Federal Government in Germany to the new, eastern *Länder*: $75 billion in 1991 and $96 billion in 1992.

When debt servicing and other income payments are set in the balance against capital inflows, there was actually a net outflow of resources from most of the east European countries in 1992. Foreign resources have therefore done little to support consumption and investment, which fell in most of the transition countries, while the rise in imports was made possible by increased export earnings. For Russia, estimates for the first three quarters of 1992 indicate an *inflow* of resources of some $4 billion, which reflects new bilateral credits and special finance being partially offset by large amounts of debt servicing.

An increasingly worrisome aspect of the programmes for financial assistance is their uneven distribution. The countries which have had most success in attracting private capital are also those which have had least difficulty in meeting the requirements for short-run balance of payments support from official sources. However, for other countries the problems of obtaining timely support appear to be considerable. Despite estimates that they would need some $20 billion of external support in 1992, the successor states to the Soviet Union *excluding* Russia obtained very few commitments of help and even less in actual disbursement. The Baltic States were only able to draw on their first IMF credits in late 1992; commitments by the G-24 have so far fallen below target and disbursement is scheduled only for the early months of 1993. The problems surrounding this *short-term assistance* – significant long-term development assistance is still a long way off – are complex: they include delays on the part of donors in meeting their pledges, but the countries themselves are often unable to meet the standard requirements, laid down by the international financial institutions and individual donors, for obtaining funds. Also their commitment to reforms appears to be hesitant in some cases, although this is sometimes a reflection of the enormous difficulties they face and doubts about their own ability to overcome them. Whatever the explanation in individual cases, delayed and inadequate assistance simply makes their problems worse.

Within eastern Europe the problems of Albania, Bulgaria and Romania are particularly difficult, although their specific situations vary considerably. All three are among the poorest countries in Europe and the circumstances surrounding their attempts to build market economies have been very unfavourable. They all started with severe macroeconomic imbalances and Bulgaria suffered more than most transition countries from the collapse of CMEA trade. The effects of the

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[73] Data for 1991. Some four fifths of annual FDI flows are among the developed market economies.

[74] United Nations Economic Commission for Europe, *Economic Bulletin for Europe*, vol.44(1992), New York, 1993, p.8 and chapter 3.

Gulf war were also negative."[75] They are now suffering considerable additional costs as a result of the war in the former Yugoslavia and by their compliance with UN sanctions on trade with the Federal Republic of Yugoslavia. Nevertheless, they have made progress in their reforms, although, not surprisingly, less than in the countries which started earlier. However, pledges of assistance have not only fallen short of IMF estimates of their needs but disbursements have repeatedly been less than promised and subject to considerable delay. The international community has also been dilatory in taking steps to share the burden of UN sanctions in an equitable manner.

The problems of the Balkan states in obtaining assistance are by no means entirely located on the side of the providers of funds, but many of the domestic difficulties are rooted in the conditions noted above. These countries not only need generous financial assistance but they also need greater understanding of their difficulties in meeting the standard pre-conditions for obtaining it. In considering the needs of the Balkan states, west European governments might recall the fact that the flow of emigrants from these countries has been increasing rapidly. At the end of 1992 they accounted for some 36 per cent of all asylum seekers from the transition countries in western Europe, or 62 per cent if those from the former Yugoslavia are excluded."[76] Moreover, they also accounted for an estimated $1 billion out of total west European government expenditure on asylum seekers of around $8 billion in 1992. The problem for western governments is therefore becoming one of *where* to spend the money rather than *whether*.

The long recession in the market economies has not only made western governments more cautious about increasing financial assistance to the transition countries, but has also left them more willing to respond to protectionist pressures from particular interests in their own countries. One of the most positive developments in the last few years has been the ability of several eastern countries to partly offset the collapse in CMEA trade by boosting their exports to the west. In this they were helped by the boom in western, particularly, German import demand in 1990-1991 and by the reduction of western trade barriers, prominently exemplified by the Association Agreements between the European Community and Poland, Czechoslovakia and Hungary."[77] The Agreements represent an improvement on the previous situation, but their commitment to open markets and free trade is heavily qualified by a gradual relaxation of restrictions on "sensitive" products, which happen to be those where the current comparative advantages of eastern Europe happen to be concentrated – and by the anti-dumping and safeguard clauses which are heavily biased against the interests of exporters. These escape clauses also create considerable uncertainty for foreign and domestic investors in eastern Europe and therefore undermine the incentives to action which would speed up the integration of the eastern countries into the international economy.

The fears of many observers now appear to have been confirmed by the application of the safeguard clause to take emergency action against steel imports from the east and the subsequent imposition of anti-dumping duties on steel tubes from Czechoslovakia, Hungary and Poland. Proposals by the EC to introduce tariff quotas on a range of products and threats of further action in other sectors point to a significant retreat from the commitment to open markets and liberal trade policies. (It should be stressed that the European Community is not alone in its qualified commitment to liberal trade policies.) This is a particularly threatening development for the eastern countries, where the few signs of a recovery in output have been largely based on export growth. Western trade restrictions not only put that recovery at risk but also threaten to undermine the reform programmes as well. They also raise questions about the credibility of western commitments to supporting the reform process in the east, as has been frankly acknowledged by one of the EC Commissioners."[78]

Helping Russia

The considerable problems facing economic reform in Russia have been greatly exacerbated by unsettled questions of political authority and legitimacy. The constitutional crisis in the country, which has now come to a head, has thrown into stark relief the seriousness of the economic problems and the inability of the authorities to respond effectively. The spectre of economic and political instability in Russia spilling over into the countries of eastern Europe has alarmed governments in both east and west. This in turn had led to a call for emergency action on the part of the G-7 to help Russia. Certainly, speedy action in a number of areas could be helpful and a number of proposals have been made, including direct food aid and loan guarantees for the construction of housing for the Russian army. However, it is not clear that an "emergency" programme is the most appropriate response. A warning was sounded in this *Survey* a year ago that "the

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[75] On the effects of the Gulf crisis of 1990 and the ensuing war, see United Nations Economic Commission for Europe, *Economic Bulletin for Europe*, Vol.42(1990), New York, 1990, pp.38-40.

[76] Based on Inter-governmental Consultations on Asylum, Refugee and Migration Policies in Europe, North America and Australia, *Asylum-seekers in Western Europe (EC and EFTA) in 1992*, Geneva, 18 December 1992, and direct communications. These estimates understate the true numbers because they exclude some 146,000 Albanian migrants in Greece and perhaps 100,000 ethnic Turks who have left Bulgaria for Turkey. Asylum-seekers in western Europe from the transition countries totalled nearly 1 million (of which 42 per cent were from the former Yugoslavia) out of a grand total of 2.6 million, see chapter 4, table 4.2.8.

[77] Agreements have also been reached with Bulgaria and Romania and they came into effect at the beginning of May and July respectively.

[78] Sir Leon Brittan, the EC Trade Commissioner is reported as believing that the EC is reneging on its promises to eastern Europe in threatening to limit severely steel imports into the Community. *The Times*, 20 March 1993. The Industry Commissioner, Herr Martin Bangemann, however, has said, referring to the possible loss of 50,000 jobs in the steel industry, that "we cannot sustain these socially without the help of central and eastern European countries. We must be sure the EC market doesn't collapse". *Wall Street Journal*, 18 February 1993.

danger is that the growing introspection of some of the leading western countries will only be broken by the onset of a major crisis in one of the transition economies and that this could lead to hasty measures which would probably be less than optimal".[79] That danger is now imminent and is increased by disagreements among the western governments as to the scope for effective action: some argue for rapid action but others warn of the dangers of wasting resources, of giving money to people "with holes in their pockets". One of the worst outcomes would be a compromise which produced a list of short-term measures, hastily put together with a maximum of publicity, but with nothing to address the chronic underlying problems of monetary instability and structural change. What is needed therefore is a policy which can reconcile the demands for action with the sceptics' fears of wasting money. At the same time, every effort needs to be made to avoid yet another "false start" on the road of Russian reform: there have been too many since 1985 and the political costs in disillusion and apathy on the part of the Russian people are already considerable.

On the basis of the arguments set out in the sections above and in previous issues of this *Survey*,[80] what appears to be needed is a commitment to a long-term programme of reform on the scale of the post-war European Recovery Programme (ERP). On the one hand, the western countries would commit themselves to a significant and sustained level of technical and financial assistance (aid) over a period of, say, 8 to 10 years, while the Russian government would undertake to draw up a long-term programme of structural reform and accept that continued aid would be contingent on intermediate targets being met. However, at present the monitoring of economic developments in Russia (as well as in other transition economies) is seriously hampered by the lack of reliable statistics. This is one of the problems that requires emergency action.[81]

Considerable efforts would be necessary to win support from the Russian population. Recent suggestions by western economic advisers to the Russian government that western aid should be seen to be benefiting the population ties in well with the discussion above on building popular support for the reforms.

The commitment of both western governments and a Russian administration to such a programme could have the same powerful effect on confidence and expectations as the Marshall Plan produced in western Europe, and not least in western Germany, in the late 1940s. The announcement that the G-7 would be prepared to make such a commitment could have more influence on domestic developments in Russia than attempts at more direct intervention, which are likely to stand little chance of success in any case.

However, although Russia is of great strategic importance for economic and political stability in eastern Europe and the rest of the world, a major commitment to Russian reform should not "crowd out" the needs of the other transition economies. Even those regarded as being in the van of the transition process are still facing considerable problems which, left unsolved or solved without sensitivity to what is politically feasible, could lead to serious setbacks. Some countries, as noted above, are lagging behind in the transition and are virtually being overlooked by western policy makers. A much broader, regional perspective of the transition process is needed rather than the current tendency for assistance efforts to treat each eastern country in isolation. This tendency probably contributed to the serious underestimation of the effects of the sudden rupture of trade relations, first among the members of the CMEA, then among the republics of the former Soviet Union, and of the former Yugoslavia, and now, it appears, between the Czech and Slovak Republics. In the cases of the former USSR and CSFR and, in the future, with the states of the former Yugoslavia, multilateral efforts to restore trade and avoid further sudden disruptions, if necessary through the creation of payments unions, should be made with international support. A regional perspective is also desirable for other reasons, not least in the preparation of major infrastructure projects.

An approach to the transition problems of Russia and eastern Europe, similar to the Marshall Plan or ERP, would imply the need for a serious reappraisal of the current methods of assessing the requirements for and coordinating the delivery of assistance. It would have to include a review of the criteria on which the international financial institutions determine their assistance, and if governments think that greater flexibility in this area would damage the credibility of these institutions then alternative arrangements should be considered. In particular the problems of the coordination of assistance, which appear to be institutional, would need to be addressed by the G-7.[82]

The secretariat's earlier suggestion that a programme along the lines of the European Recovery Programme was needed to deal with the long-run problems of transition was dismissed on a variety of grounds: that the world was now very different from the 1940s, that no single coordinating authority could now oversee the programmes of a considerable number of powerful international organizations, and that the existing institutions and arrangements were more than

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[79] United Nations Economic Commission for Europe, *Economic Survey of Europe in 1991-1992*, New York, 1992, p.10.

[80] United Nations Economic Commission for Europe, *Economic Survey of Europe in 1989-1990*, New York, 1990, pp.13-17, and the *Economic Bulletin for Europe*, vol.43(1991), New York, 1991, pp.7-9.

[81] On this problem see, *inter alia*, United Nations Economic Commission for Europe, *Economic Bulletin for Europe*, Vol.43(1991), New York, 1991, pp.4-5. The difficulties are also discussed at various points in the present volume - for a specific illustration, see section 3.3(i) below.

[82] One west European proposal, which is based on a recognition of these problems, calls for the appointment of an EC Commissioner with special responsibility for Central and Eastern Europe and the CIS and the preparation of a White Paper setting out an integrated approach to the problems of the former communist countries. The Action Committee for Europe (Chairman: Vicomte Etienne Davignon), *Proposals for Increased Assistance to Eastern Europe*, Brussels: September 1992.

capable of carrying out the job. But most of this is beside the point. The essential thing about the Marshall Plan was its clear and long-sighted vision of the donor's self-interest in supporting strong democracies and the reconstruction of market economies in western Europe and its unequivocal commitment to ensuring that they were established. The Marshall Plan, it should be remembered, also followed nearly two years of economic turmoil in western Europe and increasing complaints in the United States that billions of dollars were disappearing into western Europe without any tangible effects on reconstruction. There are signs that a reappraisal of western self-interest in a similar achievement in Russia and eastern Europe may now be under way. That provides some ground for optimism.